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In the

Supreme Court of the United States

OCTOBER TERM 1964

No. 899

MURPHY OIL CORPORATION,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit, entered in the above-entitled case on October 28, 1964, (rehearing denied November 17, 1964).

CITATIONS TO OPINIONS BELOW

The opinion of the District Court (R. 24), printed in Appendix A, hereto, *infra*, p. A-1, is reported in 230 F. Supp. 583. The opinion of the Circuit Court of Appeals, printed

in Appendix B hereto, *infra*, p. B-1, is reported in 337 F. 2d 677.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on October 28, 1964, (C.R. 4).* Rehearing was denied on November 17, 1964, (C.R. 8). The jurisdiction of this Court is invoked under 28 U.S.C., Section 1245 (1).

QUESTIONS PRESENTED FOR REVIEW

Whether a cash bonus paid by the taxpayer in connection with the execution of an oil and gas lease is to be excluded from gross income in determining taxable income.

In the alternative, if the cash bonus is not to be excluded from gross income in determining taxable income, whether such bonus similarly is not to be excluded from gross income in determining statutory depletion.

In any event, whether a cash bonus should not be excluded from gross income in determining statutory depletion when the lessor is a Governmental Agency.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and Treasury Regulations are set forth in Appendix C, *infra*, p. C-1. They are as follows: Sections 23(m) and 114(b)(3) of the Internal Revenue Code of 1939, and

* Supplemental Proceedings in the United States Court of Appeals for the Eighth Circuit as annexed to the Certified Record.

Sections 39.23(m)-1(e)(5) and 39.23(m)-10(e) of Treasury Regulations 118.

STATEMENT

1. *Preliminary*

This case presents the issue of the proper treatment for Federal income tax purposes of a cash bonus paid by the lessee in connection with the execution of an oil and gas lease.

We deal here with fundamental tax concepts which have remained the same since the passage of the 16th Amendment and the first income tax act. Tax is levied upon "taxable income." To arrive at "taxable income", we have historically utilized concepts of "gross receipts", "exclusions", "gross income" and "deductions." From "gross receipts" there are items that are "excluded" in arriving at "gross income." From "gross income" there are items which are "deducted" in arriving at "taxable income."

In the setting of receipts from oil and gas production, with which this case is concerned, a simple illustration demonstrates these principles. Assume the typical situation of a lessee acquiring a 7/8ths working interest and the lessor retaining a 1/8th royalty interest. If gross production is $80,000, the lessor is entitled to $10,000. Since a royalty interest is an item of "exclusion" for the lessee, he reports "gross income" attributable to his interest of $70,000, and thus "excludes" the $10,000 royalty. The lessee would have expenses in producing the oil which he then "deducts" in arriving at his "taxable income."

One of the lessee's deductions from "gross income" is the deduction for statutory depletion. Section 114(b)(3) of the 1939 Code, Appendix C, *infra* at C-2 provides that the amount of such deduction is 27½% " of the *gross income* from the property * * * *excluding* * * * royalties . * * *" [Emphasis added.] In the above illustration the lessee's gross income for depletion purposes is the same as his gross income for taxation purposes—$70,000. He excludes the royalty in both instances for exactly the same reason—it is income attributable to the interest of another and hence, though part of his "gross receipts", it is not part of his "gross income."

The same rules apply to an advance royalty—it is excluded from the lessee's taxable "gross income" and depletable "gross income." The question in this case concerns these fundamental precepts as applied to a cash bonus which, as this Court has held, is an advance royalty to the lessor.

2. *The Facts in the Case at Bar*

Petitioner instituted this suit in the District Court after its claim for refund had been rejected by the Internal Revenue Service. The facts are not in dispute and may be summarized as follows:

Petitioner is engaged in the exploration, drilling and production of oil and gas properties and has its principal place of business in El Dorado, Arkansas. In 1951, the Department of the Interior offered for oil and gas leasing a portion

of Government land on the Barksdale Air Force Base located in Bossier Parish, Louisiana. The announcement stated that leases would be sold on a cash-bonus basis by sealed bids at stipulated rental and royalty rates. Petitioner (through an agent) and another corporation jointly submitted three separate bids for oil and gas leases on the three tracts covered by the Department of the Interior's leasing announcement. These bids were accepted and a cash bonus in the total amount of $4,547,000 was paid to the United States. Petitioner paid 50%, $2,273,500, of the total cash bonus.

Exploration for oil and gas on these leases was successful and for its fiscal year ended May 31, 1953, Petitioner had gross income from oil and gas sales attributable to its interest of $1,056,799.46 after exclusion of $181,880 which was the aliquot portion of the cash bonus which Petitioner had paid to the United States. Statutory depletion rather than cost depletion was applicable to Petitioner's income from such leases for this fiscal year.

In computing Petitioner's tax liability for the fiscal year ended May 31, 1953, the Internal Revenue Service refused to exclude the $181,880 aliquot portion of the cash bonus from Petitioner's "gross income" but inconsistently excluded such amount from Petitioner's "gross income" from these leases for purposes of computing Petitioner's statutory depletion allowance.

The lower Courts have sustained the Government's treatment of the cash bonus paid by Petitioner to the United States.

REASONS FOR GRANTING THE WRIT

1. The decisions below are in conflict with the decision of the Fifth Circuit in *Lambert v. Jefferson Lake Sulphur Company*, 236 F. 2d 542 (1956), where it was held that payments essentially equivalent to an installment bonus were excludable by a lessee from taxable gross income. The decisions below also conflict in principle with the decisions of this Court in *Burnet v. Harmel*, 287 U.S. 103 (1932), *Anderson v. Helvering*, 310 U.S. 404 (1940) and *Burnet v. Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946).

This Court early held that a cash bonus paid to a lessor in connection with the execution of an oil and gas lease was an "advance royalty" and, hence, was to be treated as other royalties. Such a bonus is included in the lessor's gross income in determining his taxable income and likewise is included in his gross income in determining statutory depletion. As to lessors, this rule is firmly established and is not challenged by the Government. See, *e.g.*, *Anderson v. Helvering*, 310 U.S. 404 (1940); *Thomas v. Perkins*, 301 U.S. 655 (1937); *Palmer v. Bender*, 287 U.S. 551 (1933); *Murphy Oil Co. v. Burnet*, 287 U.S. 299 (1932); and *Burnet v. Harmel*, 287 U.S. 103 (1932).

As to lessees, however, the Government takes a different position. It contends that the same bonus which is an advance royalty to the lessor is not an advance royalty in determining the lessee's taxable gross income but is an advance royalty in determining gross income for purposes of computing the lessee's statutory depletion allowance. Thus,

the Government says that the lessee cannot exclude the bonus or any portion thereof from his "gross income" in computing taxable income but that he must exclude the bonus as an advance royalty from his "gross income" in computing his statutory depletion allowance. This position, as anomalous as it is unfair, has been sustained in the instant case by the Courts below, apparently relying on Circuit Court decisions[1] decided before this Court's decision in *Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946).[2]

The decisions below are in fundamental conflict with the decision of the Fifth Circuit in *Lambert v. Jefferson Lake Sulphur Company, supra.* There the taxpayers acquired the right to conduct preliminary exploratory operations and mine sulphur on certain lands. The agreement, which had many attributes of an ordinary oil and gas lease, required the taxpayers to make periodic payments during the primary term of the lease. The taxpayers deducted[3] these periodic payments in computing taxable income. The Government contended that the payments were not deductible since they were "installments of a lump-sum bonus and should be

[1] *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588 (5th Cir. 1944); *Sunray Oil Co. v. Commissioner*, 147 F. 2d 962 (10th Cir. 1945), *cert. denied*, 325 U.S. 861; *Canadian River Gas Co. v. Higgins*, 151 F. 2d 954 (2d Cir. 1945), *cert. denied*, 327 U.S. 793; and *Baton Coal Co. v. Commissioner*, 51 F. 2d 469 (3rd Cir. 1931), *cert. denied*, 284 U.S. 674.

[2] The decision in *Burton-Sutton* was announced on April 22, 1946. Certiorari in *Canadian River Gas Co. v. Higgins, supra*, note 1, was denied on March 25, 1946. Judge Learned Hand wrote a forceful dissent in *Canadian River Gas* which further supports Petitioner here. See 151 F. 2d at 957-58.

[3] The "deduction" referred to really should be an "exclusion." See part 1 of the STATEMENT, *supra* at page 3.

'capitalized'."[4] Thus, as in the instant case, a payment was made to acquire rights to explore and produce minerals; the payment was characterized as a bonus; and the Government contended that such payment represented a capital investment. The District Court and the Fifth Circuit held the payments were advance royalties and thus were excludable from the taxpayers' gross income in computing their taxable income. Significantly, the District Court in *Jefferson Lake* stated:

> "The Fifth Circuit seems to have held that advance royalties are not excludable by the lessee in Quintana Petroleum v. Commissioner of Int. Rev., 5 Cir., 143 F. 2d 588. In Commissioner of Internal Revenue v. Gracey, 5 Cir., 159 F. 2d 324, however, the Fifth Circuit apparently admits that its decision in Quintana is contrary to the principles approved by the Supreme Court in Burton-Sutton Oil Co. v. Commissioner, supra." 133 F. Supp. 197, 200, note 10.

Further, the District Court said:

> "It would appear, however, that these quarterly payments are *excludable from income by the taxpayer as advance royalties.* Admittedly, these payments were depletable as advance royalties by the lessor. Burnet v. Harmel, supra; Bankers Pocahontas Coal Co. v. Burnet, supra; Murphy Oil Co. v. Burnet, supra; Palmer v. Bender, supra. Consequently, they should be excludable as such by the lessee. Int. Rev. Code of 1939, §114(b)(4)(A), 26 U.S.C. §114(b)(4)(A) (1946 ed.). It is true that three cases from the Second, Third and Tenth Circuits are to the contrary. But those cases are inconsistent with principles expounded by the Supreme Court in Burnet, Bankers Coal Co., Murphy Oil Co. and Palmer. In addition, they were written before the opin-

[4] See 236 F. 2d at 544.

ion of the Supreme Court in Burton-Sutton Oil Co. v. Commissioner, supra. * * *" [Emphasis added.]

The Court added:

> "It is true that in the Burton-Sutton case the payments from the operator to the owner were not characterized as bonuses or advance royalties and were, in fact, materially different therefrom in that the payments there were 50 per cent of the net profit from the mineral operation. Nevertheless, though that case may be distinguishable from the one at bar on its facts, the principle there applied is applicable here. *If the payments here are advance royalties depletable by the lessor, as admitted by the Government, then they are excludable from income as advance royalties by the lessee.*" [Emphasis added.]

The Fifth Circuit affirmed the District Court expressly holding that the Court below "had reached the correct conclusion *on the grounds assigned by it as its basis.*" 236 F. 2d at 546 [Emphasis added.][5] Thus, a direct and fundamental conflict is presented by the decision below and the *Jefferson Lake Sulphur* case.[6]

The decision of the Court below is also in conflict with principles enunciated by this Court in *Burnet v. Harmel, supra, Anderson v. Helvering, supra,* and *Burton-Sutton Oil Co., Inc. v. Commissioner, supra.*

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[5] This language has erroneously been characterized by the Court below as "dictum." It is plainly a holding.

[6] In the District Court in the instant case the Government admitted that *Jefferson Lake* "probably overruled" *Quintana Petroleum Co. v. Commissioner, supra.* This admission is significant since the *Quintana* case was one of the earlier decisions supporting the Government's treatment of the bonus in the instant case. On appeal the Government retracted this admission and instead attempted to distinguish *Jefferson Lake* from the instant case and thus from *Quintana.* It appears that the Court below agrees with Petitioner as to the interpretation of *Jefferson Lake* since it questioned the "validity" of that decision, 337 F. 2d at 678.

Burnet v. Harmel held that a bonus was an advance royalty to the lessor and hence he was denied capital gains and taxed on such bonus as ordinary income but subject to the depletion allowance.

In *Anderson v. Helvering, supra*, this Court had before it the question of who was taxable upon certain oil and gas production. The key to the answer lay in the answer to the additional question of whether a seller of oil properties had retained an economic interest in the deferred payment portion of his purchase price or whether his interest in the oil and gas properties was merely security for his purchase price. If the former, the seller was taxable on the production income paid over to him. If the latter, the purchaser was taxable upon such income. In enunciating the test to answer this question, this Court stated:

> "It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest." 310 U.S. at 407.

This Court further reaffirmed the *Burnet v. Harmel* rule that a bonus payment met the test of a capital investment in oil in place:

> "Cash bonus payments, when included in a royalty lease, are regarded as advance royalties, and are given the same tax consequences." 310 U.S. at 409.

These principles were again reaffirmed by this Court in *Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946). The question in *Burton-Sutton* was whether a holder

of a "net-profits" interest in oil and gas production had an "economic interest" in oil and gas in place so that he would be entitled to the depletion deduction.[7] In holding that such an interest is an economic interest, and in characterizing the relationship between lessor and lessee with respect to types of interests in oil and gas production, this Court established the test as follows:

> "If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other." 328 U.S. at 27.

These decisions establish the tests to be applied in determining: (1) the total pool of economic interests from oil and gas production which will be entitled to the depletion allowance and (2) the manner in which this pool is to be divided among the various economic interests. A simple example illustrates the application of these principles.

Assume A (lessor) executes an oil and gas lease to B. The lease provides A is to receive a ⅛th royalty interest free and clear of any costs of production from any oil and gas produced. B is to receive ⅞ths of the production but is liable for all costs of producing the oil.[8] B pays a cash bonus to A in connection with the execution of the lease. There-

[7] This Court first held that a "net-profits" interest did not qualify as an "economic interest." See *Helvering v. Elbe Oil Land Development Co.*, 303 U.S. 372 (1938); *Helvering v. O'Donnell*, 303 U.S. 370 (1938); and *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938). The "net-profits" interests were reconsidered in *Burton-Sutton Oil Co., Inc. v. Commissioner, supra*, and *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946) where it was determined that a "net-profits" interest did qualify as part of the pool of economic interests from oil and gas production. Thus, a net-profits interest holder is entitled to depletion.

[8] The interest of the lessee is commonly termed the "working interest" since such interest is the cost bearing interest.

after B conveys a ⅛th overriding royalty out of his ⅞ths interest to C for cash.[9] Under the principles enunciated by this Court, the total pool of economic interests entitled to depletion are: (1) the cash bonus; (2) the ⅛th lessor royalty; (3) the ⅛th overriding royalty; and (4) the remaining working interest. With respect to each interest except the bonus the rules are clear as to the division of the pool of economic interests in the lease: (1) production attributable to the ⅛th royalty of A is, of course, taxed to him, he is entitled to depletion on this interest and B (lessee) excludes this interest from his income; (2) C is taxed on income attributable to his ⅛th overriding royalty, he is entitled to depletion and B similarly excludes this interest from his income; and (3) B reports the income attributable to his working interest, deducts the costs incurred to produce the income and takes depletion on his interest. Now to the bonus. It is included in the total quantum of economic interests since otherwise the lessor (A) would not be entitled to depletion on it. *Burnet v. Harmel, supra; Anderson v. Helvering, supra.* This means that it must be treated like A's royalty and C's overriding royalty and therefore B is required to exclude the bonus from his income. This is the only manner in which the lessee can treat the bonus under the tests established by this Court for determining the total pool of economic interests and the division of this pool among the different interest owners. If the lessee does

[9] While the lessor's royalty and the royalty interest conveyed to C are similar interests, the latter is customarily termed an "overriding royalty" since it is an interest created from the ⅞ths working interest rather than the ⅛th lessor royalty interest.

not exclude the bonus from his taxable gross income, the effect is double taxation on the same economic interest.[10]

Applying these principles to the case at bar, if the bonus is an advance royalty to the lessor (which it is), it must be an advance royalty to the lessee (petitioner), in which case the $181,880 aliquot part of the bonus must be excluded from petitioner's gross income for its fiscal year ended May 31, 1953.

The decision of the Court below directly conflicts with the decisions of this Court with respect to the treatment of the bonus as an advance royalty required by *Burnet v. Harmel*, the inclusion of the bonus in the total pool of economic interests required by *Anderson v. Helvering* and the reciprocal characterization of the bonus required by *Burton-Sutton*.[11]

The Government itself recognizes that the pool of economic interests include bonuses. For purposes of computing statutory depletion Regulations, § 39.23(m)-1(e)(5), Appendix A, *infra*.[12] provide:

> "*If royalties in the form of bonus payments* have been paid in respect of the property * * * the amount ex-

[10] While the Government would attribute this economic interest to both the lessee and lessor, it would permit depletion only to the lessor. This is the effect of requiring the lessee to exclude the bonus from its gross income for purposes of computing his statutory depletion allowance.

[11] Even before its decision in *Jefferson Lake Sulphur Company*, the Fifth Circuit had noted that the decision in *Burton-Sutton* had the effect of overruling its earlier decision in *Quintana Petroleum Company*. See *Commissioner v. Gracey*, 159 F. 2d 324, 326 (5th Cir. 1947).

[12] Since the taxable year here in question (1953) is a year to which the Internal Revenue Code of 1939 applies, the Regulations promulgated thereunder (Regulations 118) are also applicable. These provisions have not changed substantially under the Regulations promulgated under the 1954 Code.

> cluded from 'gross income from the property' * * * shall be an amount equal to that part of such payments which is allocable to the product sold during the current taxable year." [Emphasis added.]

Moreover, the Government recognizes that advance royalties are proper exclusions from taxable gross income. Under section 39.23 (m)-10(e) of the Regulations, Appendix C, *infra*, dealing with the computation of taxable income, if a lessee pays an advance royalty, he deducts [excludes] this from gross income, either in the year of payment or in the year the mineral product in respect of which the advance royalty was paid is sold. However, this regulation applies only to advance royalties which the lessee is required to pay "on a specified number of units of minerals annually, whether or not extracted within the year." A cash bonus paid in connection with the execution of an oil and gas lease is not, under these regulations, regarded as an advance royalty even though it is undisputed that it is taxed to the lessor as an advance royalty.[13]

Since it is undisputed that the bonus is an advance royalty under well established and settled principles of this Court, the above regulation must be invalid as contrary to the decisions of this Court to the extent such regulation does not accord bonuses the same treatment as other advance royalties.

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[13] In the instant case, of course, the lessor paid no tax on the bonus received since it was the United States. However, the character of the payment is still that of an advance royalty. Had the lessor in the instant case been a person subject to tax, the bonus would have been included in his income as an advance royalty, *i.e.*, ordinary income subject to depletion.

2. Petitioner contends, in the alternative, that if the bonus paid to the United States is not to be excluded from its taxable gross income then it similarly should not be excluded from its depletable gross income. Surely "gross income" means the same thing both in section 22(a) and in section 114(b)(3) of the 1939 Code and the inconsistent treatment required by Treasury Regulations, *viz.*, that petitioners must *include* the bonus in taxable gross income but must *exclude* the bonus from depletable gross income cannot be justified. It is a clear rule of statutory construction that identical words used in the same statute are presumed to have identical meaning. *Helvering v. Wilshire Oil Co., Inc.*, 308 U.S. 90 (1939); *Commissioner v. Ridgeway's Estate*, 291 F. 2d 257 (3rd Cir. 1961).

It is difficult enough, in light of *Burton-Sutton Oil Co., Inc., supra*, to justify giving the bonus one treatment to the lessor and a different one to the lessee. A fortiori, there can be no possible justification in holding it to be two different things at the same time to the lessee, *viz.*, that it is a capital investment in computing the lessee's "gross income" subject to tax, but is an advance royalty in computing "gross income" subject to percentage depletion; that it is the lessee's capital investment in computing cost depletion, but is an advance royalty in Computing statutory depletion. In fact, in order to avoid the effect of the *Anderson v. Helvering*, *Burton-Sutton* and *Jefferson Lake*, the Government's position must be to insist, despite *Burnet v. Harmel*, 287 U.S. 103 (1932) and *Murphy Oil Co. v. Burnett*, 287 U.S. 299 (1932), that a bonus is not a royalty. This position inevitably leads to the conclusion that if a bonus is not a royalty to be

excluded from the lessee's taxable "gross income", it cannot be a royalty to be excluded from the lessee's depletable "gross income"; and if it is not a royalty to be excluded from the lessee's depletable "gross income", the "bonus exclusion" provisions of Regulations, Section 39.23(m)-1(e)(5), are clearly invalid.

Quintana Petroleum Co. v. Commissioner, *supra*, and the other Circuit Court cases above mentioned, to the extent that they sanction the "bonus exclusion", while at the same time holding the bonus not to be a royalty to the lessee, are clearly wrong. In *Jefferson Lake* the Fifth Circuit so held in overruling the *Quintana* case.

3. Although the Circuit Court decisions sustaining the Government's position are far from clear, apparently they felt it necessary to reach such a result to avoid "double depletion." Petitioner has clearly demonstrated that since the bonus is included in the total pool of economic interests, there would be a doubling-up of depletion only in the sense that there is also a doubling-up of taxable income. Since, in this case, the United States is the lessor and hence took no depletion, the supposed reason for sustaining the exclusion from depletable gross income vanishes. Accordingly, Petitioner should not be required to exclude the bonus from depletable gross income in this case.

4. We submit that the recurring importance of the problem in the administration of the tax laws and the conflict between the decisions below and those of this Court and the Court of Appeals for the Fifth Circuit warrant review and a definitive adjudication of the issue by this Court.

Bonus payments in connection with the execution of oil and gas leases are standard and customary in the entire industry. Major oil companies and independent oil producers pay out millions of dollars every year in lease bonuses. In the interest of uniform administration of our tax laws they are entitled to consistent treatment of the bonus. Not only are the present rules inconsistent, they are not uniformly applied. In some areas companies are eprmitted to exclude the bonus or an aliquot part thereof from taxable gross income; in some areas companies are permitted to capitalize the bonus and not exclude it from depletable gross income; and in some areas companies are required to follow the inconsistent treatment provided in the regulations. The reason for this lack of uniform administrative enforcement is not clear. The issue has seldom been raised and Regulations largely ignored. Since the issue has been raised in the case at bar, it is time this Court hear the issue and resolve it consistent with its earlier decisions.

Moreover, every writer who has considered this question has criticized the existing rules as promulgated in the Treasury Regulations[14] and Treasury officials informally have criticized them as the ancient "swoose", neither swan nor goose. Since the mid-1940s no court or writer has attempted to justify the Government's position on the merits. Even these earlier cases are unconvincing in their attempt to rationalize a dual inconsistent treatment of the bonus. This

[14] See, *e.g.*, Gilpin, "Special Depletion Problems Relating to Gas Production, 12th Ann. S.W. Legal Foundation Inst. on O.&G. Law and Tax., 347, 418 (1961) and Freling, Bonus Payments Through the Looking Glass, P-H Oil & Gas Taxes, ¶ 2027 (1962).

is especially true in light of Judge Learned Hand's dissent in the *Canadian River Gas* case, and the Fifth Circuit's decision in *Jefferson Lake* which overrules its earlier decision in *Quintana*.

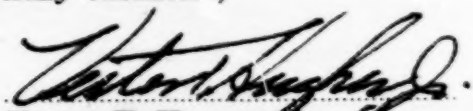
The tax rules governing oil and gas transactions are largely interpretative and do not result from a highly articulated statutory pattern. In light of this approach to oil and gas tax law, this Court should hear and decide this issue.

In addition, the identical issue is now pending in the Fifth Circuit in *Shamrock Oil and Gas Corp. v. Commissioner*, 35 T.C. 979. Petitioner is advised that the *Shamrock* case will probably not be decided in the Fifth Circuit until late spring, and unless the Fifth Circuit overrules its decision in the *Jefferson Lake Sulphur Company* case, the *Shamrock* decision will present a second conflict with the decision below in the instant case. Accordingly, since that decision would present a further conflict, presumably this Court would grant certiorari in that case if it is not granted here. But at such later date Petitioner would be without remedy if this Court sustains the principle for which Petitioner is here contending. Moreover, review is justified now by the need to resolve the existing conflict between the Eighth and Fifth Circuits and between the Eighth Circuit and principles enunciated by this Court.

CONCLUSION

For the foregoing reasons, Petitioner respectfully submits that this petition for writ of certiorari should be granted.

Respectfully submitted,



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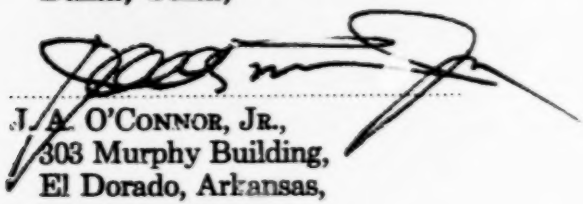

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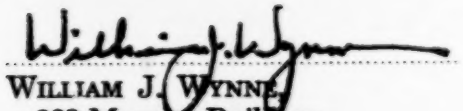

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CERTIFICATE OF SERVICE

I, Vester T. Hughes, Jr., one of the attorneys for Murphy Oil Corporation, Petitioner herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 9th day of February, 1965, I served copies of the foregoing Petition for Writ of Certiorari upon the Solicitor General, Department of Justice, Washington 25, D. C., by air mail, postage prepaid, and upon counsel of record who represented the United States of America, Respondent herein, in the court whose judgment is sought to be reviewed, in accordance with paragraph 2(a) of Rule 33 of the rules of this Court.

Vester T. Hughes Jr.

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Attorney for Petitioner.

APPENDIX A

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
EL DORADO DIVISION

No. E.D. 989

MURPHY CORPORATION,

Plaintiff,

v.

UNITED STATES OF AMERICA,

Defendant.

Memorandum Opinion

This is a suit brought by plaintiff, Murphy Corporation, against the Government to secure a refund of a portion of its 1953 federal income tax allegedly unlawfully and erroneously exacted. The problem presented is the proper treatment for tax purposes of an aliquot part of a cash "bonus" which plaintiff paid to the Government in 1951 for an interest in an oil and gas lease on certain federally owned lands in Bossier Parish, Louisiana, from which lands oil and gas were produced in commercial quantities during the tax year in question. The cause has been submitted to the Court on the pleadings, a written stipulation of all controlling facts, and memorandum briefs.

Plaintiff has its principal place of business in El Dorado, Union County, Arkansas, and files its federal tax returns with

the District Director of Internal Revenue at Little Rock. During 1953 and prior years plaintiff was largely engaged in the production of oil and natural gas from wells located in Arkansas, Louisiana, and elsewhere.

In the spring of 1951 the Government advertised for bids for an oil and gas lease covering certain lands in the Barksdale Airforce Base near Shreveport, Louisiana. The advertisement announced that the lands would be leased for a cash bonus to be paid in advance, and for a royalty of one-eighth of the oil and gas produced from the properties. Plaintiff, acting through an agent, submitted a bid and obtained a one-half interest in a lease which the Government executed later in the year. The amount of bonus which plaintiff paid for its interest was $2,273,500.

In computing its income taxes from year to year plaintiff takes advantage of the depletion allowance provisions of sections 611 and 613(b)(3) of the Internal Revenue Code of 1954 and with respect to 1953 claimed a depletion allowance as provided by sections 23(m) and 114(b)(3) of the Internal Revenue Code of 1939. Since the rights of the parties are governed by the 1939 Code further Code references are to that Code. Likewise, references to regulations are to those promulgated under the 1939 Code.

Under sections 23(m) and 114(b)(3) lessors and lessees of oil or gas producing properties were entitled to claim as deductions from their income for tax purposes annual allowances of 27.5 percent of gross income from the leased premises during the taxable year to compensate for the

depletion of oil and gas in the ground. The allowances were required to be prorated equitably between lessors and lessees, and the lessees were required by section 114(b)(3) to exclude from gross income from the properties "an amount equal to rents or royalties paid or incurred by the taxpayer in respect of the property." The reason for the latter requirement was, and is, that rents and royalties paid to lessors are taxable income to them against which they are entitled to claim depletion, and unless the lessees are required to eliminate such rents and royalties from gross income from the properties when calculating their own depletion allowances, there would be a duplication of the allowances.

With regard to a cash bonus paid for an oil and gas lease,[1] it is settled law that as far as the lessor is concerned, the money which he receives by way of bonus is taxable income against which depletion allowances may be claimed. See Anderson v. Helvering, 310 U.S. 404; Bankers Pocahontas Coal Co. v. Burnet, 287 U.S. 308; Murphy Oil Co. v. Burnet, 287 U.S. 299; Burnet v. Harmel, 287 U.S. 103.

The lessee, of course, is taxed ultimately upon his or its net income, which is gross income as defined by section 22 of the Code, less the deductions authorized by section 23, including depletion allowances. In determining a lessee's gross

[1] A "cash bonus" for an oil and gas lease is simply a cash payment made to the lessor in consideration of the execution of the lease. It has no relation whatever to actual production from the leased premises and is not affected by production or lack of production. Normally, if production is achieved, the lessor receives a royalty of one-eighth of the oil and gas produced free and clear of all costs of production; the lessee receives the remaining seven-eighths of the production out of which he must recover his investment, pay operating expenses and derive his profit, if any.

income under section 22 the Treasury has consistently taken the position that the amount of cash bonus paid for the lease is a capital investment and cannot be excluded from gross income for section 22 purposes. For section 22 purposes the bonus is not regarded as "advance royalty" because it has no relation to actual production from the properties. See in this connection Treasury Regulations 118, §§ 39.23(m)-10(a) and (e).

However, as far as the depletion allowance is concerned, the Treasury has taken the view that a bonus paid for a lease must be treated like an "advance royalty," and must be excluded from gross income from the property when the annual depletion allowance is calculated. In this connection section 39.23(m)-1(e)(5) provides in part that if "royalties in the form of bonus payments have been paid in respect to the property in the taxable year or any prior years * * * the amount excluded from 'gross income from the property' for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the current taxable year * * *."

Thus, it will be seen that when the lessee comes to calculate his income tax, he is not permitted to exclude the bonus payment from gross income for section 22 purposes, but must exclude an aliquot part of it from his gross income when computing his depletion allowance under section

23(m).[2] It is this alleged inconsistency in the treatment of the bonus in determining the lessee's tax liability which gives rise to this lawsuit. Plaintiff contends, alternatively, that if the bonus must be excluded from gross income for purposes of computing depletion allowance under sections 23(m) and 114(b)(3), it must also be excluded from gross income for section 22 purposes, or that if it is to be included in gross income for purposes of section 22, it must also be included for purposes of sections 23(m) and section 114(b)(3). These alternative contentions were brought before the Court in the following manner:

The portion of the bonus paid by plaintiff in 1951 and allocable to 1953 was $181,880. When plaintiff prepared and filed its income tax return for 1953 it excluded the sum just mentioned both in its initial computation of gross income under Section 22 and in its computation of depletion allowance under section 23(m) and section 114(b)(3). Having so excluded that sum from gross income, plaintiff proceeded to calculate and pay the resulting tax. The Commissioner disallowed the double exclusion of the bonus and assessed a deficiency of $73,069.77. Plaintiff paid this deficiency and when its claim for a refund was denied administratively, it commenced this action.

[2] In view of this situation it is perhaps fair to say that a lessee who claims the statutory depletion allowance is never able to recover the amount of the cash bonus, *as such*. This does not mean necessarily that the bonus payment in fact will not be recouped by the lessee if production is efficient and continues. By continually availing himself of the 27.5 percent depletion allowance from year to year a lessee may recoup all of his investment, including the bonus, and much more.

It is the position of the Government that regardless of consistency or inconsistency in the treatment of the bonus when determining the tax liability of the lessee, the regulatory scheme whereby the lessee must exclude an aliquot part of the bonus from gross income when computing his depletion allowance but is not permitted to exclude it when computing his gross income under section 22 has the force of law, and that plaintiff is not entitled to prevail.

The contention advanced by plaintiff is not novel. It has been considered and rejected by the Courts of Appeals for four Circuits, Sunray Oil Co. v. Commissioner, 10 Cir., 147 F. 2d 962; Canadian River Gas Co. v. Higgins, 2 Cir., 151 F. 2d 954; Baton Coal Co. v. Commissioner, 3 Cir., 51 F. 2d 469; Quintana Petroleum Co. v. Commissioner, 5 Cir., 143 F. 2d 588. More recently, it has been rejected by the Tax Court in Shamrock Oil & Gas Corporation v. Commissioner, 35 T.C. 979, 1040 ff., and in Fitzsimons v. Commissioner, 37 T.C. 179.[3]

In an effort to avoid the force of the Courts of Appeals' decisions just cited counsel for plaintiff contends that those decisions have been overruled by implication by the holdings of the Supreme Court in Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, and Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, and that the Quintana Petroleum

[3] The Shamrock case, supra, is now on appeal to the Court of Appeals for the Fifth Circuit, and this Court suggested at one time that decision of the instant case await the determination of the Court of Appeals in *Shamrock*. However, counsel on both sides requested the Court to proceed to decision here at this time since the date of the appellate court's decision in *Shamrock* is uncertain. Having considered the matter, the Court decided to accede to coursels' request.

Co. case has been in effect overruled by the Court of Appeals for the Fifth Circuit in Lambert v. Jefferson Lake Sulphur Co., 5 Cir., 236 F. 2d 542, affirming Jefferson Lake Sulphur Co. v. Lambert, E.D. La., 133 F. Supp. 197.

While there is some language in the Burton-Sutton case which perhaps lends some support to plaintiff's contention, neither Burton-Sutton nor Kirby Petroleum involved the problem presented here, and for that reason neither case can be considered as directly in point. Nor is the Court persuaded that the Supreme Court in either case intended to overrule or criticize the results reached in the cases typified by Sunray Oil Co. v. Commissioner and Canadian River Gas Co. v. Higgins, both supra.

It may be conceded that Judge J. Skelly Wright took a broad view of the holding in Burton-Sutton, and rendered a decision in Jefferson Lake Sulphur Co. v. Lambert, supra, 133 F. Supp. 197, which is consistent with the position assumed by plaintiff here. And it is true that the Court of Appeals in that case affirmed the decision of the District Court. However, the weight to be given here to the affirmance in Lambert is diminished by the fact that the affirmance was based primarily on an entirely different ground from that on which the district court proceeded, and thus the language in the opinion of the Court of Appeals approving the reasoning of the district court may be considered as dictum.

In the Shamrock case, supra, the Tax Court discussed the question in great detail and declined to follow the Jeffer-

son Lake case. Similarly, the Tax Court specifically refused to follow *Jefferson Lake* in Fitzsimons v. Commissioner, supra. In both *Shamrock* and *Fitzsimons* the view was taken that Burton-Sutton Oil Co. v. Commissioner, supra, was not in point.

With the law in the state that has been outlined, this Court does not feel justified in holding at this time that the older cases upholding the Government's position have been overruled, or that the decisions of the Tax Court in *Shamrock* and *Fitzsimons* were wrong, or that the regulatory scheme of which plaintiff complains is invalid. Before so holding this Court would require a stronger showing of a change in the law than has been made.

Plaintiff advances in its briefs another contention which appears to the Court to be subsidiary to the principal contentions which have been mentioned. This contention is that in no event should plaintiff be required to exclude the aliquot part of the bonus from gross income for depletion allowance purposes since the Government is not a taxpayer and does not claim depletion allowances as do private lessors. The Court is convinced that this subsidiary contention is devoid of merit. The depletion allowance is a matter of legislative grace, and the statutory requirement that rents or royalties be excluded from a lessee's gross income for depletion allowance purposes does not depend upon the status of the lessor as a taxpayer. That the Government pays no income tax and takes no depletion allowances is no reason

to give plaintiff the benefit of an additional allowance to which it would not be entitled were the lessor a private individual or corporation.

From what has been said, it follows that the complaint must be dismissed.

Dated this 1st day of April, 1964.

J. SMITH HENLEY

United States District Judge

APPENDIX B

United States Court of Appeals

FOR THE EIGHTH CIRCUIT

No. 17,666

MURPHY OIL CORPORATION,

Appellant,

v.

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court for the Western District of Arkansas.

[October 28, 1964.]

Before MATTHES, BLACKMUN and RIDGE, Circuit Judges.

PER CURIAM.

Murphy Oil Corporation, Appellant, brought this action to recover income taxes alleged to have been erroneously and illegally assessed and collected by the Government for the taxable year ending May 31, 1953.

The facts were presented by a stipulation, are fully and accurately stated in the trial court's opinion, and place in issue the proper treatment for tax purposes, under applicable statutes and Treasury Regulations, of an aliquot part of a cash bonus which appellant paid to the Govern-

ment in 1951 for an interest in an oil and gas lease on federally owned land in Louisiana.

Appellant's claim for refund is premised on the theory that the bonus paid by it is an advance royalty and that an aliquot part thereof should be excluded from appellant's gross income in determining both taxable income and statutory depletion; that if the cash bonus is not to be excluded from its gross income in computation of taxable income such bonus should not be excluded from gross income for purpose of computing its statutory depletion; and that in any event Treasury Regulation 39.23(m)-1(e)(5) under the 1939 Internal Revenue Code is invalid insofar as it requires the bonus exclusion in a situation where, as here, the recipient of the bonus is a governmental agency.

The trial court, Judge Henley, after carefully considering appellant's contentions, the applicable statutes and regulations, and what is regarded as the controlling decisional law, concluded that appellant was not entitled to recover and dismissed the complaint. 230 F. Supp. 583 (1964). This appeal follows.

A thorough examination of the authorities cited and others having any relevancy to the question presented satisfies us that the judgment appealed from is correct and we affirm on the basis of the trial court's opinion. Like Judge Henley, we are not persuaded that *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946) has the effect of changing the law as announced by the Courts of Appeals and by the Tax Court in cases cited in the trial court's opinion. Since the issue presented in this case was

not before the Supreme Court in *Burton-Sutton*, we have difficulty in adopting appellant's suggestion that the broad generalization contained in the two sentences taken from the *Burton-Sutton* opinion demonstrates fundamental error in the prior decisions of the Courts of Appeals.[1]

Jefferscn Lake Sulphur Co. v. Lambert, 133 F. Supp. 197, affirmed 236 F. 2d 542 (1956) which lends support to appellant's position was in our view influenced in large part by the statements of the Supreme Court in *Burton-Sutton*, quoted in the margin. Inasmuch as we do not regard such language, seemingly controversial, as having the effect of overruling long standing Treasury Regulations and decisional law, the validity of *Jefferson Lake* is in our view, greatly diminished and certainly it does not control the disposition of this case.

Affirmed.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit.

[1] In *Burton-Sutton* the court was concerned with the tax treatment of a lease payment in the form of net profits. In its discussion, the court made these statements seized upon by appellant in support of its contentions; 328 U.S. at page 27. "If they are capital investments to one, they are capital sales to the other. If they are rents and royalties paid out to one, they are rents and royalties recieved by the other." We note that Freling, *Bonus Payments Through the Looking Glass*, P-H OIL & GAS TAXES ¶ 2027 (1926) cited by appellant, takes issue with the court's view in this language: "At least one sentence in the foregoing quotation from *Burton-Sutton* is incorrect, and the Tax Court [Shamrock Oil & Gas Corp. 35 T.C. 979, 1054. et seq. (1961)] rightly makes short shrift of the notion. Merely because an expenditure is a capital investment to the payor does not necessarily mean that there has been a capital sale by the payee." Page 2514 of § 2027.

APPENDIX C

Statutes and Regulations Involved:

Statutes:

Internal Revenue Code of 1939:

Section 23(m) [now INT. REV. CODE OF 1954 § 611 (a)]: "*Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the

trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

"For percentage depletion allowable under this subsection, see section 114(b), (3) and (4)."

Section 114(b) (3) [now INT. REV. CODE OF 1954 § 613(a), (b)]: "*Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph."

Regulations 118:

Section 39.23(m)-1(e) (5) [now Treas. Reg. § 1.613-2(c) (5) (i), (ii), (iii) 1960]: "In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the 'gross income from the property'. If royalties in the form of bonus payments have been paid in respect of

the property in the taxable year or any prior years, or if advanced royalties have been paid in respect of the property in any taxable year ending prior to December 31, 1939, the amount excluded from 'gross income from the property' for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the current taxable year. If advanced royalties have been paid in respect of the property in any taxable year ending on or after December 31, 1939, the amount excluded from 'gross income from the property' for the current taxable year on account of such payments shall be an amount equal to the deduction for such taxable year taken on account of such payments pursuant to § 39.23(m)-10(e)."

Section 39.23(m)-10(e) [now Treas. Reg. § 1.612-3(b) (1), (2), (3) (1960)]: "If a lessee or other owner of operating rights in one or more mineral properties is required to pay royalties on a specified number of units of mineral annually, whether or not extracted within the year, and may apply any amounts paid on account of units not extracted within the year against the royalty on mineral thereafter extracted, he may at his option treat the advanced royalties so paid or accrued in either one of the following manners:

"(1) As deductions from gross income for the year the advanced royalties are paid or accrue; or

"(2) As deduction from gross income for the year the mineral product in respect of which the advanced royalties were paid is sold.

The option contained in this paragraph shall apply only to advanced royalties paid or accrued in taxable years ending on or after December 31, 1939. Every taxpayer must make an election as to the treatment of all such advanced royalties in his return for the first taxable year ending on or after December 31, 1939, in which such amounts are paid or accrue. A taxpayer will be considered to have made an election in accordance with the manner in which such items are treated in the return. A failure to deduct any such items for the year paid or accrued will constitute an election to have all such items treated in accordance with subparagraph (2) of this paragraph. Any election made under this section is binding for all subsequent years and the taxpayer must treat all advanced royalties paid or accrued in such subsequent years in the same manner."